IN THE

Supreme Court of the United States

OCTOBER TERM 1956

MAX PUTNAM AND ELIZABETH PUTNAM
Petitioners

vs. — No. 25

COMMISSIONER OF INTERNAL REVENUE
Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE PETITIONERS

A. Lyman Beardsley
220 Roanoke Building
Minneapolis 2, Minnesota

Richard E. Williams
800 Hubbell Building
Des Moines, Iowa
Counsel for Petitioners

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CITATIONS

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court of the United States (R. 14-21) is reported unofficially in 13 *T.C.M.* 458. The opinion of the United States Court of Appeals for the Eighth Circuit is reported in 224 *F. 2d* 947. (C.C.A. 8th) (R. 27-34)

JURISDICTION

The judgment of the United States Court of Appeals for the Eighth Circuit was entered on August 11, 1955 (R. 35). Petition for Writ of Certiorari was filed January 5, 1956, and was granted February 27, 1956. The jurisdiction of this court is invoked under 28 *U.S.C. Sec.* 1254.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the United States Internal Revenue Code of 1939, adopted by the act of February 10, 1939, Ch. 2, 53 Stat. 1-504 and Regulations applicable thereto, are set forth in the appendix infra. pp. 21-25.

QUESTION PRESENTED

The corporation borrowed from a bank, and the taxpayer petitioner co-signed the corporate notes as guarantor. The corporation's business was not successful, and its assets were sold. The proceeds of the sale did not cover its indebtedness, and the taxpayer petitioner had to pay the corporation's notes to the bank. Were the taxpayer petitioner's losses non-business debts under Section 23(k)(4) of the United States Internal Revenue Code of 1939, or did such losses result from a transaction entered into for profit within the meaning of Section 23(e)(2) of the United States Internal Revenue Code of 1939?

STATEMENT

The facts as found by the Tax Court and by the Court of Appeals are substantially as follows:

The petitioners are husband and wife, and reside at Des Moines, Iowa, where Max Putnam is, and has been, engaged in the general practice of law since 1931 (R. 14).

On August 17, 1946, the petitioner, Max Putnam, and two other parties named Case and Quinn brought about the incorporation of Whitehouse Publishing Company for the purpose of carrying on a general printing and publishing business (R. 15). Putnam furnished all of the consideration for the issuance of stock, which was issued in equal amounts

to Putnam, Case and Quinn (R. 15, 16). Case and Quinn agreed to, and did, execute to Putnam their individual promiss y notes, each equal to one-third of the consideration furnished by Putnam to the corporation for its stock, which notes were secured by a pledge by Case and Quinn of the stock issued to them in Whitehouse Publishing Company (R. 16, 29). The debts of Case and Quinn to the petitioner became worthless in 1947 (R. 19, 29).

In February 1947 Case's notes to petitioner were cancelled and his shares of stock in Whitehouse were assigned to petitioner (R. 16). In July 1947 Quinn's notes to petitioner were cancelled and his shares of stock in Whitehouse were assigned to petitioner (R. 16).

On August 20, 1946, petitioner and Whitehouse Publishing Company borrowed $12,075.00 from Central National Bank and Trust Company of Des Moines for the use of the corporation, and they signed a promissory note therefor as co-makers (R. 16). Whitehouse Publishing Company was the primary obligor on the notes, and Petitioner Putnam was in fact acting only as guarantor (R. 19).

In March 1947 the petitioner and Whitehouse borrowed an additional $5,000.00 from Central National Bank, and again signed a promissory note as co-makers (R. 16), although Whitehouse was the primary obligor and Putnam guarantor thereof (R. 19).

By the middle of 1947 is was evident that the publishing venture was unsucecssful (R. 16). In July 1947 Whitehouse sold its assets and ceased to do business (R. 17). From the proceeds of the sale of corporate assets, the first obligation to the bank in the amount of $12,075.00 was reduced to the sum of $3,500.00, but no payment was made on the $5,000.00 obligation to the bank (R. 17). As a consequence, after all corporate assets had been disposed of, an indebtedness to the bank in the amount of $8,500.00 remained, together with interest thereon (R. 17).

In December 1948 the petitioner Putnam paid the balance of the indebtedness to the bank, consisting of principal of $8,500.00 and interest of $505.21 (R. 17).

On petitioners' 1948 income tax return, they claimed a business bad debt deduction of $9,005.21, consisting of the principal and interest paid by petitioner to the bank (R. 17). The Commissioner of Internal Revenue proposed to treat said amount as a non-business bad debt, and to impose the short-term capital loss limitations thereon. The Commissioner's contention has been upheld, both in the Tax Court of the United States and in the United States Court of Appeals for the Eighth Circuit.

SUMMARY OF ARGUMENT

The Commissioner of Internal Revenue recognizes that petitioner Putnam suffered a loss as a consequence of the performance of his guarantee of the corporate obligations to the bank. He urges that the performance by Putnam of his obligations under the guaranty gave rise to a debt. He concludes that, since the "debt" was worthless when it came into existence, it became worthless during the year in which the guaranty was performed, and that the loss resulting therefrom is deductible as a bad debt. He categorizes the "debt" as non-business, and seeks to impose the short-term capital loss limitations on the deductibility of the loss.

The Commissioner's reasoning fails to recognize that Section 23(k) of the 1939 Internal Revenue Code, which section was enacted in 1942, was intended as a safe-guard against the deductibility of losses on family and friendship loans which were actually gifts. He fails to recognize that Section 23(k) was not intended to apply to obligations to reimburse which arose by operation of law, and was in-

tended to apply only to the loss suffered by the actual creditor. Section 23(k) should apply only to transactions recognized as creating a debt at their inception.

Section 23(k) is applicable only where a debt has come into existence. The guaranty executed by Putnam created no debt. It merely entitled Putnam to subrogation to the bank's claim against Whitehouse, a claim long since worthless. The performance by Putnam of his obligations under the guaranty could create a debt, under his right to reimbursement by Whitehouse, only if there were a reasonable hope and expectation of recovery at the time of such performance. Since the primary obligor, Whitehouse Publishing Company, a corporation, had been completely liquidated at the time of petitioner's performance of the guaranty, there was no hope or expectation of recovery by Putnam from the corporation. Hence, there was no debt so as to bring the loss under Section 23(k). Furthermore, for a loss resulting from a bad debt to fall within the purview of Section 23(k), the debt must have *become* worthless in the year of loss. The alleged "debt" could not have *become* worthless during the year, since it was worthless at the inception. Therefore, the loss suffered by petitioner Putnam is not deductible under Section 23(k), but is deductible under Section 23(e)(2) as a loss resulting from a transaction entered into for profit.

ARGUMENT

THE PETITIONER'S LOSS RESULTING FROM THE PERFORMANCE BY HIM OF HIS GUARANTEE OF THE CORPORATE OBLIGATION TO THE BANK WAS NOT THE CONSEQUENCE OF A DEBT WHICH BECAME WORTHLESS WITHIN THE TAXABLE YEAR. PETITIONER'S LOSS WAS A LOSS SUSTAINED DURING THE TAXABLE YEAR INCURRED IN A TRANSACTION ENTERED INTO FOR PROFIT.

I

Section 23(k) of the Internal Revenue Code of 1939 applies only where the taxpayer has extended credit to the debtor, and does not apply to obligations arising by operation of law.

Section 23(k) of the Internal Revenue Code of 1939 was enacted in 1942, and was intended as a safeguard against the deductibility of losses on family and friendship loans which were actually gifts and were not the result of the operation of a trade or business or the result of a transaction entered into for profit. It was intended to prevent the easy deductibility of bad debts under the prior law, which had led to abuses in the form of making loans, without any reasonable expectation of repayment, to friends or related persons. The 1942 enactment attempted to solve the problem by dividing loans into business and non-business categories, and by limiting the deductibility of all bad debts in the non-business category.

The Commissioner of Internal Revenue, in his construction of Section 23(k), has gone beyond the intent and purpose of the enactment and has gone well beyond the matter of denying deductions where purported loans were actually

gifts. He has attempted to bring within the purview of Section 23(k)(4) many losses which were not intended to be governed as to deductibility by that section, and has attempted to destroy the full deductibility of losses sustained in truly commercial transactions. To some extent he has been successful in procuring narrow judicial construction in support of his interpretation of the law.

Section 23(k) was obviously not intended to apply generally to obligations to reimburse arising by operation of law. However, the Commissioner has attempted to apply the bad debt provisions to obligations arising by operation of law if the obligations are such that they fall within the non-business category. On the other hand, if the obligation to reimburse arises by operation of law, but is not incurred in trade or business, and is not incurred in a transaction entered into for profit, then the Commissioner contends that such obligation does not result in a debt within the purview of Section 23(k). It would seem that obligations arising by operation of law should all fall within or all fall without the scope of the bad debt provisions. The Commissioner seeks to make the bad debt provisions apply only with reference to those obligations arising by operation of law, which obligations, upon becoming worthless, can be classified as non-business bad debts. If the obligation arising by operation of law is not incurred in trade or business or in a transaction entered into for profit, he contends that the obligation, upon becoming worthless, is not a debt of the type contemplated by Section 23(k).

To illustrate the Commissioner's inconsistency with reference to the treatment of obligations arising by operation of law which have become worthless, compare his position in the instant case, and others similar thereto, with the position successfully taken by him in *Katherine J. Hanes vs. Commissioner of Internal Revenue*, 2 T.C. 213. In the

Hanes case the taxpayer sought to take a deduction for a bad debt, on the ground that she had been defrauded when she purchased bogus oil paintings for her home, a consequence of fraudulent representations made to her by the vendor. She argued that, as a result of the misrepresentation by the seller, she had a cause of action against the seller, which was a debt; that the debt had become worthless, and therefore she should be entitled to a bad debt deduction.

The Tax Court pointed out that Sections 23(e) and 23(k) were mutually exclusive, and that the nature of the item in dispute must determine which is applicable. The court concluded that Section 23(e) was applicable because the transaction resulted in a loss rather than a debt as that word is used in sub-Section (k). Since the loss was not one resulting from a transaction entered into for profit, it was not deductible under Section 23(e).

Thus, in the *Hanes* case the Commissioner successfully contended that the claim against the vendor, resulting as it did by operation of law, did not give rise to a debt within the purview of sub-Section (k).

In the instant case and other similar cases cited and discussed infra, the Commissioner contends that obligations arising by operation of law, as a consequence of transactions entered into for profit, do come within the scope of the bad debt provisions. Not only the inconsistency but the reason therefore is apparent. If the obligation arises by operation of law in a personal transaction, the Commissioner seeks to apply Section 23(e) under which it is not deductible. If the obligation arises by operation of law in a transaction entered into for profit, the Commissioner contends that Section 23(k) is applicable where its deductibility is limited in accordance with the short-term loss provisions. Certainly it is the obligation and responsibilty of the

Commissioner to protect the revenue, but not at the expense of assuming completely inconsistent positions purely for the purpose of arriving at the maximum tax liability.

The foregoing illustration of the Commissioner's inconsistency between the position taken by him in circumstances such as those found in *Hares* and circumstances such as exist in the instant case, demonstrates that federal tax law ought not to be dependent upon technical distinctions in the common law developed to adjust the relations between the parties who are primarily and secondarily liable. The making of such distinctions by the courts has given rise to unnecessary confusion in this field of federal tax law. For example, the Tax Court, and other courts, distinguish between the subrogation debt of a guarantor against a dissolved corporation, as compared with a fully liquidated or bankrupt corporation. See *Greenspon vs. Commissioner*, 8 T. C. 431.

The reasoning of the Circuit Court in the instant case would seem to require a distinction between treatment of the loss of the guarantor and the loss of an indemnitor, and would indicate that a release or waiver of the right of reimbursement by a guarantor, prior to insolvency of the principle debtor and prior to payment by the guarantor, would affect the nature of the loss and the extent of its deductibility.

Inequitable distortions of the type described could and should be avoided, and the existing confusion with reference to the applicability of Section 23(k) could be dispelled if Section 23(k) were limited in its application to those circumstances to which it was originally intended to apply. It is the *creditor* to whom the bad debt provisions should and were intended to apply. Regardless of how the surety may be characterized under local law, the fact remains that he will be called upon to perform only under circumstances

comparable to those under which an insurer must perform. At the time the surety relationship is established, the surety does not anticipate that the debtor will be unable to pay. He does not become a surety because of any reliance upon the prospect that the debtor will reimburse him. His expectation is that the debtor will pay when the debt becomes due. If the debtor does not do so, the surety relationship arrangement results in a loss to the surety because he has over-estimated the financial prospects of the debtor. The surety, being bound by a contract adequately supported by consideration, must pay. The obligation to pay, and the loss resulting therefrom, result from the original guaranty. It does not result from the extension of credit to the debtor.

The matter pending before this court is of such general interest that the court should clarify the scope and range of Section 23(k) so as to avoid the growing confusion with reference to its application, and the application of similar sections of the law under the 1954 Internal Revenue Code.

Even greater confusion with reference to this area of federal tax law may arise under the 1954 Code unless there is a specific clarification of the application of the bad debt provisions. Section 166(f) of the 1954 Code permits a deduction for any payments made by a guarantor or indemnitor of a non-corporate obligation where the funds received by the borrower are used in the trade or business of the borrower. If payment is made at a time when the borrower's obligation to the creditor is worthless, apart from the guaranty or indemnity, the payment will be treated as a debt which became worthless within the taxable year, and the rule as to bad debts, other than non-business bad debts, will apply. The effect of the new provision is to exempt a certain group of guarantors from the rule that a debt, worthless when acquired, cannot afterwards become worthless. This rule was established in *Eckert vs. Burnet*,

283 U. S. 110. This would seem to indicate congressional approval of the application of the *Eckert* rule as to those guarantors not covered by the new provision, and, in effect, require such guarantors to prove that the debt they acquired became worthless within the taxable year, or be denied a bad debt deduction. In other words, by taking this one group of guarantors out of the rule of *Eckert vs. Burnet*, all others remain within it and must take their deduction, if any, under some provision of the Code other than the bad debt provisions. This is no more than an application of the rule of construction *expressio unius est exclusio alterius.* It should be noted also that the new provision has the effect of permitting a deduction as a bad debt of payments made by indemnitors under the same circumstances as payments by guarantors, although an indemnitor has no right of subrogation or reimbursement against the original debtor.

A decision by this court to the effect that Section 23(k) was intended only to apply to those circumstances where the loss results from the extension of credit by the taxpayer to the debtor, would eliminate the wide confusion presently existing, and would bring about a uniform construction by the courts of the provisions of the 1954 Code.

II

Section 23(k) of the Internal Revenue Code of 1939 is not applicable, because there was no debt; and if there was a debt, it did not become worthless during the year.

The execution of the guaranty by Putnam did not create a debt, and, as a consequence, the Commissioner's contention that the bad debt provisions apply, must rest upon the proposition that the performance of the guaranty in 1948 gave rise to a debt in favor of the taxpayer.

Under the law of suretyship this debt may have been the result of Putnam's subrogation to the bank's claim against Whitehouse, or the result of Putnam's right to reimbursement by Whitehouse.

Under Putnam's right to subrogation, he merely became subrogated to the claim which the bank had held against Whitehouse,—a claim which became worthless when Whitehouse was liquidated and insolvent. The law is clear that the acquisition of a worthless claim, even for consideration, cannot be the basis for the deduction of a bad debt under Section 23(k).

> *Mountain Wholesale Co., Inc. vs. Commissioner*, 17 T. C. 870;
>
> *Layton vs. Commissioner*, 11 (C. C. H.) T. C. M. 1115;
>
> *Heimbach vs. Commissioner*, 13 (C. C. H.) T. C. M. 210.

Hence, the only basis on which any debt covered by Section 23(k) could exist in Putnam's hands would be under his right of reimbursement resulting from his payment on the guaranty.

It has always been recognized that a debt may come into existence *only* where there is a reasonable hope and expectation of repayment. The right to reimbursement does not arise until the guarantor or surety has made payment to the principal creditor. Certainly no debt could arise in Putnam's favor against Whitehouse Publishing Company which had been fully liquidated, since there was no debtor from whom a reasonable expectation of recovery or repayment existed.

As previously pointed out, the Tax Court has held that the bad debt provisions do not apply with reference to the guaranty of a corporate obligation, if the corporation be dissolved prior to the performance of the guaranty. See:

Greenspon vs. Commissioner, supra;
Hanna, Jr., vs. Commissioner, 10 (C. C. H.) T. C. M. 566, Docket Nos. 25706 and 25707;
J. B. Book, Jr., vs. Commissioner, 8 (C. C. H.) T. C. M. 101, Docket No. 15312.

The Tax Court has also held that the bad debt provisions do not apply with reference to a guaranty where the subrogation debt has been wiped out by reorganization or bankruptcy. See *Ingersoll vs. Commissioner*, 7 T. C. 34.

The Second Circuit, in *Fox vs. Commissioner*, 190 Fed. 2d 101, concluded that the bad debt provision could have no application where the debtor was both insolvent and dead. The court said:

> "Clearly, too, the transaction was not then one involving a bad debt, since she had not even made the payment which alone would give rise to a claim in her favor. Nor could payment ten years later create a debt out of something less than even the proverbial stone. It is utterly unrealistic to consider the payment as one made in any expectation of recovery over or of any legal claim for collection. Actually it was merely the fulfillment of her contractual obligation of the earlier date. The bad debt provision thus had no direct application; only by straining the statutory language can we erect here a disembodied debt against an insolvent and long dead debtor."

Thus the courts have consistently recognized the principal that if, at the time payment is made by a guarantor, the primary debtor is dead or non-existent, or if there is no legal or practical possibility of any recovery over against such debtor, no debt arises, and Section 23(k)(4) is not applicable. If there is no reasonable expectation of recovery, there is no debt. See:

W. F. Young, Inc., vs. Commissioner, 120 F. 2d 159;
American Cigar Co. vs. Commissioner, 66 F. 2d 425, 427 (2nd Circuit) Certiorari denied 290 U. S. 699;
C. B. Hayes, 17 B. T. A. 86;
Layton vs. Commissioner, 11 (C. C. H.) T. C. M. 1115.

Section 23(k)(4), in order to be applicable, requires not only the existence of a debt, but also requires that the debt *become* worthless within the taxable year. Even if it should be held here that a debt, within the meaning of Section (23(k)(4), arose in favor of Putnam against the insolvent and fully liquidated corporation, such debt was worthless when acquired, and could not *become* worthless within the taxable year so as to bring the loss within the purview of Section 23(k)(4).

In *Eckert vs. Burnet*, supra, the petitioner, who was on a cash basis, attempted to deduct as a bad debt the amount of a note given to satisfy his liability as a guarantor of a corporate debt. Mr. Justice Holmes stated: "The debt was worthless when acquired. There was nothing to charge off." The court inferred that the payment might be deductible as a loss when the note was actually paid.

In *Shiman vs. Commissioner*, 60 F. 2d 65 (2nd Circuit), it was held that a payment in discharge of a guaranty was deductible as a debt and need not be considered as a non-deductible gift. However, in *Fox vs. Commissioner*, supra, the holding of *Shiman vs. Commissioner* was overruled, and the court permitted a deduction under Section 23(e)(2) as a loss incurred in a transaction entered into for profit.

Despite some criticism of the decision in *Eckert vs. Burnet, supra,* and attempts to explain it away, the rule of *Eckert vs. Burnet,* supra, has, in most cases except the instant case, been followed and is manifestly correct.

> *Pollak vs. Commisioner,* 209 F. 2d 57 (3rd Circuit);
> *Cudlip vs. Commissioner,* 220 F. 2d 565 (6th Circuit);
> *Edwards vs. Allen,* 216 F. 2d 794 (5th Circuit, affirming 114 F. Supp. 672).

In *Edwards vs. Allen,* supra, it was stated:

"Indeed, this result, i. e., the requirement of worthlessness is implicit in the statute. Section 23(k) ap-

plies only to 'debts which become worthless within the taxable year.' As the Supreme Court pointed out, a debt which is worthless when acquired by the taxpayer cannot be said to become worthless in his hands."

In the District Court decision which was affirmed by the Fifth Circuit in *Allen vs. Edwards,* still stronger language was used:

> "Counsel * * * argues that the essence of the transaction and the cause of the loss was the failure of the taxpayers to be able to recover over and against the principal debtor on the right of subrogation. The acquisition of such claim against the principal debtor was not the essence or the purpose of the transaction. Taxpayers did not make payment * * * for the purpose of acquiring a worthless claim against the corporation, but made those payments for the purpose of satisfying their liability on their guaranties.
>
> The loss was caused by the necessity of making payment on their liability and not by their failure to obtain salvage."

Even where the guarantor, upon payment of the debt is subrogated to all rights of the creditor, the courts have rejected that theory as a basis for the finding of a debtor-creditor relationship. In *Pollak vs. Commissioner,* supra, the 3rd Circuit said:

> "It is doubtless true * * * that under the doctrine of subrogation the corporation became indebted to (the taxpayer) for the payments made by him on his endorsements and guaranty as and when he made them. But these payments were made under a legal obligation and guaranty which he had entered into previously at a time when he believed that the corporation would prosper and that he would not lose as a result of his action. It is utterly unrealistic to suggest '' * * that Leo L. Pollak when he entered into this transaction' fully intended and expected to be repaid by the then existing solvent corporation."

In *Cudlip vs. Commissioner,* supra, the Sixth Circuit rejected completely the Commissioner's contention that tax-

payers' rights under subrogation gave rise to a debt which became worthless ~~immediately~~ upon coming into existence. The court said:

> "Taxation is concerned with realities; and we concur * * * that the contentions here advanced by the Commissioner are completely unrealistic. The argument that, because of payment on the guaranty, petitioners would have a claim for reimbursement against the insolvent corporation that had no assets, and that, therefore, their loss was a debt which became worthless during the taxable year in which they made the payment, is illusory and untenable."

The theoretical remedies of subrogation and reimbursement should not be the basis for imposing a substantial tax liability where there, as here, they have little foundation in reality.

In a well considered study appearing in University of Pittsburgh Law Review, Volume 17, pages 83-92, this comment is made:

> "A valid distinction exists between a loan and a guaranty, and the tax consequence of each should correspondingly differ. A loan is usually made as an investment and should be treated as any other capital investment; a guaranty is not an asset at all, but is a liability."

The Tax Court and the court below have refused to follow the *Allen, Pollak* and *Cudlip* cases, supra, and they hold that payments made by guarantors of corporate debts are deductible only as non-business debts. The court below makes no reference in its decision to the requirement that a debt, in order to be deductible, must *become* worthless within the taxable year. *Eckert vs. Burnet*, supra, and the rule therein laid down and applied by the other circuits is not even mentioned in the decision below. It would appear from the decision below that there is no requirement that the debt *become* worthless within the taxable year.

Nevertheless, the statute, in Section 23(k)(1), specifically requires that the debt *become* worthless within the taxable year, and this court in *Eckert vs. Burnet*, supra, has recognized that, as an essential requirement to the application of the bad debt provision, worthlessness must occur during the taxable year.

It is necessary to conclude that the Eighth Circuit erred in applying Section 23(k), because neither of the elements essential for the application of that section existed here. There was here no debt because of the absence of reasonable expectation of recovery; and there was no worthlessness occurring within the year, since the subrogation claim was worthless from its inception.

III

Section 23(e)(2) of the Internal Revenue Code of 1939 is applicable because taxpayer's loss was incurred in a transaction entered into for profit.

It is universally recognized that a loss, such as the one in issue here, arising out of a guaranty by a stockholder of a corporate obligation, is a loss incurred in a transaction entered into for profit. See *Pollak vs. Commissioner*, supra; *Cudlip vs. Commissioner*, supra; *Edwards vs. Allen*, supra. It does not appear that the Commissioner contends or has at any time contended that Putnam was prompted, in the making of the guaranty, by any motive other than the hope and expectation of profit through the success of the corporate undertaking.

Neither is there any issue as to the reality of petitioner's loss. The only isue is and has been whether or not the loss is within the purview of Section 23(k) or Section 23(e)(2) of the 1939 Code.

It has long and universally been recognized that Sections 23(e) and 23(k) are mutually exclusive. *Edwards vs. Allen,* supra; *Spring-City Foundry Co. vs. Commissioner,* 292 U.S. 182. A loss resulting from a transaction entered into for profit, other than a loss resulting from a bad debt within the scope of Section 23(k), is deductible in its entirety as a loss incurred in the transaction entered into for profit under Section 23(e)(2). *Pollak vs. Commissioner,* supra; *Edwards vs. Allen,* supra; *Cudlip vs. Commissioner,* supra; *Fox vs. Commissioner,* supra.

In the instant case, the petitioner has suffered a loss which was incurred in a transaction entered into for profit, and since Section 23(k) is not applicable, both because of the absence of a debt and the absence of worthlessness occurring within the year, the residuary terms of Section 23(e) are applicable and taxpayer's loss is deductible in full under that section.

Section 23(e) is a general broad residuary clause which covers those losses, and only those losses, which are not covered by the other more particular subsections of Section 23. Since the loss is recognized to have occurred and was the consequence of a transaction entered into for profit, and since the loss did not result from a debt becoming worthless within the year, then Section 23(e)(2) is applicable and petitioner's loss deductible in full in the year of the performance by petitioner of his guaranty.

IV

The authorities relied upon by the court below are neither pertinent nor controlling on the issue.

The only issue in *Burnet vs. Clark,* 287 U.S. 410 was whether payments made by a guarantor were incurred in his business so as to permit a net loss carry over into the

following year. The deduction claimed here does not depend upon establishing that Putnam incurred his loss in a trade or business. The deduction is claimed by him under Section 23(e)(2) relating to transactions entered into for profit, and not under Section 23(e)(1) relating to losses incurred in trade or business.

In *Edwards vs. Allen*, supra, the Court of Appeals summarily rejected the contention that the loss was not incurred in a transaction for profit, stating:

> "This contention is so clearly at variance with what seems to us to be a common every-day interpretation of simple language that clear and convincing authority in support of this contention would have to be brought forward * * * to support such construction."

In *Pollak vs. Commissioner*, supra, the court said:

> "* * * we all know that a stockholder who thus loans his credit to a corporation does so in hope and expectation that the corporation, with the additional credit thus made available to it will succeed in preserving or adding to the value of his stock * * *"

In the cases cited, and in *Ansley vs. Commissioner*, 217 F. 2d 252 (3rd Circuit), the courts held that the intention of the stockholder in guaranteeing corporate obligations was to increase the value of his stock, and that such intention is that which is required to render a transaction one which was entered into for profit.

In the opinion of the court below, without citation of authority, it is stated:

> "the great weight of authority is that a transaction * * * wherein petitioner was compelled as co-maker or guarantor to pay the balance due on notes * * * is a non-business bad debt deductible as a short-term capital loss."

The court below also relies generally upon *Commissioner*

vs. Smith, 203 F. 2d 610 (2nd Circuit) and *W. F. Young, Inc. vs. Commissioner*, 120 F. 2d 159 (First Circuit).

The issue in *Commissioner vs. Smith* did not deal with the secondary liability of a stockholder guarantor, but only with the question of whether or not debts acknowledged to have become worthless were or were not incurred in a trade or business.

In *Young, Inc. vs. Commissioner*, supra, the First Circuit held that advances made to an insolvent corporation, without expectation of repayment and without hope of later prosperity of the corporation, were gifts and not business bad debts. The court emphasized that there was no reasonable expectation of recovery at the time the advances were made.

It is, therefore, apparent that the decision of the court below was predicated upon a misconstruction of the application of Section 23(k) and Section 23(e), and in reliance upon authorities that are not pertinent to the issue here.

The decision of the Court of Appeals in this case has created a conflict where none should exist, and has given rise to confusion and uncertainty which should be resolved by this court.

CONCLUSION

The decision of the court below should be reversed.

A. LYMAN BEARDSLEY
220 Roanoke Building
Minneapolis 2, Minn.

RICHARD E. WILLIAMS
800 Hubbell Building
Des Moines, Iowa
Counsel for Petitioners

APPENDIX

INTERNAL REVENUE CODE OF 1939

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * * * * * * * * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business;

* * * * * * * * * * *

(k) *Bad Debts.*—

(4) (As added by Section 124(a) of the Revenue Act of 1942, supra) Non-business debts.—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(26 *U.S.C.*, 1952, *Sec.* 23)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(e)-1. *Losses by Individuals.*—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for

profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not, prior to the filing of the return, been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the Internal Revenue Code: Sections 23(g) and 117, relating to capital losses, section 23(h), relating to wagering losses; section 24(b), relating to losses from sales or exchanges of property between persons designated therein; section 112, relating to recognition of gain or loss upon sales or exchanges of property; section 118, relating to losses on wash sales of stock or securities; section 251, relating to income from sources within possessions of the United States; and section 252, relating to citizens of possessions of the United States. See section 213 as to limitation upon losses sustained by nonresident aliens.

In general, losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, *bona fide,* and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. See section 113(b). For special provisions with respect to war losses, see section 127.

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Sec. 29.23(k)-6 (As amended by T.D. 5458, 1945-1 Cum. Bull. 45). *Non-Business Bad Debts.*—In the case of a taxpayer, other than a corporation, if a non-business bad debt becomes entirely worthless within a taxable year beginning after December 31, 1942, the loss resulting therefrom shall be treated as a loss from the sale or exchange of a capital asset held for not more than six months. Such a loss is

subject to the limitations provided in section 117 with respect to gains and losses from the sale and exchange of capital assets. A loss with respect to such a debt will be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a non-business debt which is recoverable in part during the taxable year. Nor are the provisions of this subdivision applicable in the case of a loss resulting from a security as defined in section 23(k)(3). A non-business debt is a debt, other than a debt from the loss from the worthlessness of which is incurred in the taxpayer's trade or business and other than a debt evidenced by a security as that term is defined in section 23(k)(3). The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer's trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transactions covered by section 23(e) is "incurred in trade or business" under paragraph (1) of that section.

The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthihless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a non-business debt for the purpose of this section.

To illustrate: A, an individual engaged in the grocery business and who makes his income tax returns on the calendar year basis, extends credit on an open account to B in 1941.

(1) In 1942 A sells the business, but retains the claim against B. The claim becomes worthless in A's hands in 1943. A's loss is controlled by the non-business debt provisions. While the original consideration was advanced by A in his trade or business, the loss was not sustained as a proximate incident to the conduct of any trade or business in which he was engaged at the time the claim became worthless.

(2) In 1942 A sells the business to C, but sells the claim against B to the taxpayer, D. The claim becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(3) In 1942 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands. C's loss is not controlled by the non-business debt provisions. While C did not advance any consideration for the claim or acquire it in carrying on his trade or business, the loss was sustained as a proximate incident to the conduct of the trade or business in which he was engaged at the time the debt became worthless.

(4) In 1942 A dies, leaving the business to his son, C, but the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss in controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(5) In 1942 A dies and while his executor, C, is carrying on the business, the claim against B becomes worthless. The loss sustained by A's estate is not controlled by the non-business debt provisions. While C did not advance any consideration for the claim on behalf of the estate or acquire it in carrying on a trade or business in which the estate was engaged, the loss was sustained as a proximate incident to the conduct of the trade or business in which the estate was engaged at the time the debt became worthless.

(6) In 1942, A, in liquidating the business, attempts to collect B's claim, but finds that it has become worthless. A's loss is not controlled by the non-business debt provisions, since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.